

**STATE OF CALIFORNIA  
DEPARTMENT OF INSURANCE  
45 Fremont Street, 24th Floor  
San Francisco, California 94105**

**NOTICE OF PROPOSED ACTION AND  
NOTICE OF PUBLIC HEARING**

**RH- 04041191  
August 23, 2005**

**SUBJECT OF HEARING:**

Notice is hereby given that a public hearing will be held regarding the adoption of amendments to the California Code of Regulations ("CCR") Title 10, Chapter 5, Subchapter 3, Article 3.5, Minimum Reserve Standards for Valuation of Disability Insurance Contracts, Sections 2312 (Claim Reserves), 2312.5 (Contract Reserves), and 2315 (Specific Standards for Morbidity, Interest and Mortality). With some exceptions, the proposed amendments conform to revisions that have been made by the National Association of Insurance Commissioners (NAIC) to the text of NAIC Health Insurance Reserves Model Regulation (NAIC Model 10), upon which text the current CCR sections 2312, 2312.5, and 2315 are based.

**AUTHORITY AND REFERENCE:**

The Insurance Commissioner proposes the adoption of amendments to Title 10, Chapter 5, Subchapter 3, Article 3.5, Minimum Reserve Standards for Valuation of Disability Insurance Contracts, sections 2312, 2312.5, and 2315 pursuant to the authority vested in him by sections 997(a) and 10489.95 of the California Insurance Code. The Commissioner's decision on the proposed amendments will implement, interpret, and make specific the provisions of Insurance Code sections 985, 997, and 10489.15(a).

**HEARING DATE AND LOCATION:**

Notice is hereby given that a public hearing will be held to permit all interested persons the opportunity to present statements or arguments, orally or in writing, with respect to the proposed regulations as follows:

<b>Date and time:</b>	<b>October 24, 2005 10:00 am*</b>
<b>Location:</b>	<b>Department of Insurance Hearing Room 45 Fremont Street, 22<sup>nd</sup> Floor San Francisco, CA 94105</b>

\*The hearing will continue on the date noted until all testimony has been completed or 5:00 p.m.,

whichever is earlier.

PRESENTATION OF WRITTEN AND/OR ORAL COMMENTS; CONTACT PERSONS:

All persons are invited to present oral and/or written comments at the scheduled public hearing. Written comments should be addressed to the contact person:

Nancy Hom, Staff Counsel III  
California Department of Insurance  
45 Fremont Street, 24th Floor  
San Francisco, CA 94105  
Telephone: (415) 538-4144

Questions regarding procedure, the hearing, comments, or the substance of the proposed action should be addressed to the contact person listed above. If she is unavailable, inquiries may be addressed to the backup contact person:

Susan Stapp, Assistant Chief Counsel  
California Department of Insurance  
45 Fremont Street, 24th Floor  
San Francisco, CA 94105  
Telephone: (415) 538-4403

DEADLINE FOR WRITTEN COMMENTS:

All persons are invited to submit written comments on the proposed regulations during the public comment period. **The public comment period will end at 5:00 p.m. on October 24, 2005.** All written comments, whether submitted at the hearing, or by U.S. mail, or by e-mail or facsimile, must be received by the Insurance Commissioner, c/o the contact person at the address listed above, no later than **5:00 p.m. on October 24, 2005.** Any written materials received after that time will not be considered.

COMMENTS TRANSMITTED BY E-MAIL OR FACSIMILE:

The Commissioner will accept written comments transmitted by e-mail provided they are sent to the following e-mail address: [homn@insurance.ca.gov](mailto:homn@insurance.ca.gov). The Commissioner will also accept written comments transmitted by facsimile provided they are sent to the attention of the contact person at the following facsimile number: (415) 904-5729. **Comments sent to other e-mail addresses or other facsimile numbers will not be accepted. Comments sent by e-mail or facsimile are subject to the October 24, 2005 deadline for written comments set forth above.**

ACCESS TO HEARING ROOMS:

The facilities to be used for the public hearing are accessible to persons with mobility impairments. Persons with sight or hearing impairments are requested to notify the contact person(s) for the hearing in order to make special arrangements, if necessary.

#### **ADVOCACY OR WITNESS FEES:**

Persons or groups representing the interests of consumers may be entitled to reasonable advocacy fees, witness fees, and other reasonable expenses, in accordance with the provisions of Title 10 of the California Code of Regulations, in connection with their participation in this matter. Interested persons should contact the Office of the Public Advisor at the following address to inquire about the appropriate procedures:

California Department of Insurance  
Office of the Public Advisor  
300 Capitol Mall, 17<sup>th</sup> Floor  
Sacramento, CA 95814  
(916) 492-3559

A copy of any written materials submitted to the Public Advisor regarding this rulemaking must also be submitted to the contact person for this hearing. Please contact the Office of the Public Advisor for further information.

#### **INFORMATIVE DIGEST:**

##### **POLICY STATEMENT OVERVIEW**

Each year life and disability insurers are required by law to prepare and file an annual statement which, among other things, discloses financial information about the company which the Department of Insurance reviews to ensure that the company is operating in accordance with applicable laws. Each annual statement contains information on the sufficiency of the insurer's reserves to cover future obligations, such as claims. Existing law (CCR sections 2312, 2312.5, and 2315) prescribes how reserves must be calculated and maintained, and what levels of reserves are required by law. All three of these sections are derived from the NAIC's Health Insurance Reserves Model Regulation (NAIC Model 10).

The Commissioner now proposes to amend sections 2312, 2312.5, and 2315. By and large the amendments are identical to or closely parallel recent revisions made by the NAIC to the NAIC Model Regulation upon which sections 2312, 2312.5, and 2315 were originally based. The actuarial bases (such as mortality, morbidity) for valuation of policies under the NAIC Model Regulation and also the Department of Insurance's own minimum reserve standards regulations must be updated from time to time to reflect changing conditions and more recent data. The proposed amendments will achieve this objective.

In addition to the obvious benefits of using more recent data as opposed to older data, the proposed amendments will promote uniformity of standards among different states. The current revisions to the

NAIC model regulation are in the process of being adopted by several different states. Both insurers and consumers benefit when administrative costs related to compliance with multiple, inconsistent regulatory requirements imposed by different states are reduced. The proposed amended regulations tend to serve this purpose by ensuring that California's regulatory requirements in this area are as consistent with those of other states as is possible under California law. Everyone stands to benefit when insurers, operating in compliance with California law, are able to devote additional resources -- resources which would otherwise be expended satisfying multiple, inconsistent regulatory regimes -- to improving their financial stability or providing better products to consumers. The proposed regulations are reasonably necessary to the degree to which they help to achieve this goal.

The proposed amendments to sections 2312, 2312.5, and 2315 implement, interpret, and make specific the reserving requirements of Insurance Code sections 985, 997, and 10489.15(a) by specifying and clarifying the way in which the reserves shall be calculated and maintained. The overall objective is to facilitate enforcement of the minimum statutory reserving requirements in a manner that is also consistent with the NAIC standards and with the NAIC standards as adopted by other states.

#### SUMMARY OF EXISTING LAW; EFFECT OF PROPOSED ACTION.

Section 2310 of the Department of Insurance's existing regulations requires that the adequacy of an insurer's reserves be determined on the basis of three separate categories of reserves: claim reserves, contract reserves, and premium reserves. The actuarial bases (e.g., mortality and morbidity bases) for the first two categories are being updated in the proposed regulations to more accurately reflect current conditions and recent data. In addition, the proposed regulations expand upon existing regulations to clarify existing and new requirements, and to promote consistency with the NAIC Model Regulation and the regulations of other states to the extent that they too adopt regulations based on the NAIC Model.

#### Section 2312 Claim Reserves.

The current section 2312 sets forth general rules governing the minimum reserves that insurers must maintain to cover all incurred but unpaid claims (including claims accrued and unaccrued, reported and unreported). The standards established by this section help to ensure that insurers have enough money in their reserves to pay claims, and that insurers are subject to uniform reserving standards.

The proposed amendments to section 2312 update the section by incorporating recent amendments to the NAIC Health Insurance Reserves Model Regulation (NAIC Model 10). Existing law does not contain the NAIC updates.

The language in section 2312 (b)(1)(B) 1. and 2. allows insurers to continue using their current morbidity standards for disability income claims that have already occurred. It also gives the insurers the option of calculating reserves for individual and group disability income claims incurred on or after January 1, 2005 according to morbidity standards that are based on other acceptable experience. The language of this section has been amended to conform to the language of the NAIC Model Regulation, but the requirements are essentially unchanged. This amendment promotes uniformity with the NAIC standards.

The capital letters in subsections of Section 2312(b)(1)(B)2.(ii) have been changed to Roman numerals to conform them to an outline format.

Section 2312(b)(1)(B)3. (including parts (i) and (ii)) gives insurers a choice of morbidity standards for disability income claims incurred prior to January 1, 2005. The insurer may choose to calculate its claim reserves using the minimum morbidity standard in effect as of the date the claim was incurred, or it may choose to use the minimum morbidity standards set forth in section 2312(b)(1)(B)1. and 2. Once the insurer elects to calculate reserves as defined in 1. and 2., all future valuations must be on that basis to promote consistency. Existing section 2312(c) does not state whether approximations of claims data based on groupings or averages may be used. Sometimes insurers do not have sufficient data for the required calculations unless they use groupings and averages. The amendment to section 2312(c) clarifies the standard by stating that the insurer may use approximations based on groupings and averages. The amendments to section 2312(c) also change the word “employed” to “valued” because “valued” more accurately describes what is done with the reserve data. Except for the re-numbering of paragraphs, which is a non-substantive change, all of the proposed amendments to section 2312 simply update the section by incorporating provisions from the current version of the NAIC Model Regulation.

#### Section 2312.5 Contract Reserves.

The current section 2312.5 governs contract reserves, which are reserves for claims which may occur in the future. Section 2312.5 states when contract reserves are required and how contract reserves must be calculated. The proposed amendments to section 2312.5 clarify and expand the regulation so that it is consistent with the NAIC Model Regulation. Existing law does not set forth the new requirements.

The language added to section 2312.5(a)(1)(B) allows insurers to use data collected on a block basis (as opposed to data maintained on an individual basis for each insured) if the premiums are developed on a block basis to support risk assumed and expected expenses for the block. The rationale is that if the insurer develops premiums on a block basis, then it makes sense and is consistent to allow the insurer to maintain reserves on a block basis. The new language requires an actuary to certify that the premium development was on a block basis. The certification helps to ensure compliance with this section. The language of the proposed amendment to section 2312.5(a)(1)(B) is taken directly from the NAIC Model Regulation, with one exception: for clarity, the Department of Insurance expanded the citation at the end of the paragraph from a partial citation, “subsection (b),” to a complete citation: “subsection 2312.5(b).”

The new language set forth as section 2312.5(a)(5) is taken directly from the NAIC Model Regulation. It provides that the insurer’s contract reserve shall incorporate provisions for moderately adverse deviations. This requirement is consistent with recent changes in the Department of Insurance’s Actuarial Opinion and Memorandum Regulations (California Code of Regulations Title 10, Chapter 5, Subchapter 3, Article 17, section 2580.1 et seq.), which require adequacy of reserves to be justified on moderately adverse deviations.

The number (1), the heading “Basis,” and the substitution of (A) for (1) have been added to organize and clarify the provisions of section 2312.5(b) as amended to incorporate provisions of the NAIC Model

## Regulation.

The new language added to section 2312.5(b)(1)(A) concerning morbidity tables is from the NAIC Model Regulation: “The morbidity tables shall contain a pattern of incurred claims cost that reflects the underlying morbidity and shall not be constructed for the primary purpose of minimizing reserves.” This means that insurers may not reduce morbidity levels simply to justify a reduction in reserves for contracts for which tabular rates are not specified in section 2315.

The current version of section 2312.5(b)(1)(A) contains a typo which is corrected in the proposed regulations by striking “or” on line four of the first paragraph and inserting the word “of” in its place

Section 2312.5(b)(1)(A)1 and 2312.5(b)(1)(A)2 consist of new language taken from the NAIC Model Regulation. These new paragraphs give actuaries some guidance on implementing the requirements of section 2312.5(b)(1)(A) as amended.

Section 2312.5(b)(1)(A)1 has been added to allow morbidity assumptions to be the best estimate of anticipated future experience, but not to incorporate any expectations of future morbidity improvement. However, the last sentence of paragraph 1 is intended to provide allowances for a known event, such as a new drug release that would significantly affect morbidity assumptions, even though at this time there are no specific examples that could be noted in the recent past that would have met this standard. This is intended to be an extremely rare event.

Section 2312.5(b)(1)(A)2., taken from the NAIC Model Regulation, provides insurers with a limited exception to the requirements of section 2312.5(b)(1)(A)1. Section 2312.5(b)(1)(A)2. provides that insurers which have reserve bases that do not meet the requirements of section 2312.5(b)(1)(A)1. and which have business in force as of the effective date of the regulations may continue using their existing reserve bases if they convince the Commissioner that continued use of the reserve bases is acceptable.

Section 2312.5(b)(1)(C)2 is language taken from the NAIC Model Regulation. It has been added as an amendment to section 2312.5 because there is a need for uniform actuarial standards applicable to long term care contract reserves. The new language means that contract reserves for long term care individual policies or group certificates issued on or after January 1, 2005 will be determined using the updated mortality data set forth in the amended section 2315 rather than older data that would be less accurate for recent claims. The remainder of this subsection sets forth standards for contract reserves for terminations other than mortality.

2312.5(b)(4) is language taken from the NAIC Model Regulation. It states that the contract reserve on a policy basis for long term care insurance shall not be less than the net single premium for nonforfeiture benefits at the appropriate policy duration, where net single premium is computed according to the proposed regulations. This proposed regulation promotes solvency by establishing a minimum amount that each insurer must maintain as a contract reserve for long term care policies, which is never less than the nonforfeiture cash surrender value, if the policy has nonforfeiture benefits.

The remaining changes to this section consist of corrections to typographic errors and renumbering of

paragraphs so that new language from the NAIC Model Regulation fits into the outline format of the existing section 2312.5.

#### Section 2315 Specific Standards for Morbidity, Interest, and Mortality.

From time to time, in light of new experience, standards for morbidity, mortality, termination rates, and other data are updated after investigations by entities such as the Society of Actuaries generate newer, and thus more accurate or relevant data. California Insurance Code section 997(a) authorizes the Commissioner to regularly incorporate updated data into California law. The NAIC Model Regulations contain updated, specific minimum morbidity standards and termination assumptions, along with explanations on how the new data should be used in determining reserves. Section 2315 of the proposed regulations, as amended, now contains the updated standards for morbidity and mortality, along with explanations on how the standards should be used. Section 2315 as amended also contains the updated mortality standards for long-term care policies. Existing law does not contain the updated standards or explanations on how they should be used, and does not create special, more precise provisions for long-term care policies.

Specifically, Section 2315(a)(1)(A)2.(i) sets forth a table of adjustment factors and adjusted termination rates for individual disability claims incurred on or after January 1, 2005. This section also explains the derivation of the tables and sets forth instructions on how they should be used. Section 2315(a)(1)(A)2.(ii) gives insurers some flexibility for older claims by providing that for claims incurred prior to January 1, 2005 the insurer may choose to perform its calculations using either the minimum morbidity standard in effect for contract reserves on currently issued contracts as of the date the claim is incurred, or the new standard set forth in section 2315(a)(1)(A)2.(i). Section 2315(a)(1)(A)2.(ii)(III) provides that once an insurer chooses a morbidity standard to use for its reserve calculations all future valuations must be on that basis. In other words, the insurer may not switch back and forth between one standard and the other – once it has chosen a standard it must continue using the chosen standard for those particular reserve calculations. This is consistent with the proposed language in subsections 2312(b)(1)(B)3.(i) and (ii). This restriction promotes consistency and reduces manipulation of data.

Section 2315(c) allows insurers to determine the mortality basis for all policies except long-term care individual and group policies issued on or after January 1, 2005 by reference to tables permitted by Insurance Code section 10489.2(a). The proposed regulation as amended allows them to determine the mortality basis for long-term care individual or group policies issued on or after January 1, 2005 by reference to the 1994 Group Annuity Mortality Static Table. These amendments permit the use of the updated mortality standards for long-term care policies.

The remaining changes to section 2315 simply renumber paragraphs so that new language can be incorporated into the format of the existing regulation.

#### DOCUMENTS INCORPORATED BY REFERENCE

The following documents have been incorporated by reference into the proposed regulations:

- The 1985 Commissioners Individual Disability Table A (85CIDA);
- Transactions of the Society of Actuaries (TSA) XXXVII, pp.457-463, exhibits 3a, 3b, 3c, 4 and 5;
- The 1985 Commissioners Individual Disability Table C (85CIDC);
- The 1994 Group Annuity Mortality Static Table.

#### MANDATES ON LOCAL AGENCIES OR SCHOOL DISTRICTS

The proposed regulations do not impose any mandate on local agencies or school districts. There are no costs to local agencies or school districts for which Part 7 (commencing with section 17500) of Division 4 of the Government Code would require reimbursement.

#### COST OR SAVINGS TO ANY STATE OR LOCAL AGENCY OR SCHOOL DISTRICT OR IN FEDERAL FUNDING:

The Commissioner has determined that the proposed regulations will result in no cost or savings to any state agency, no cost to any local agency or school district that is required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of the Government Code, no other nondiscretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State.

#### ECONOMIC IMPACT ON BUSINESSES AND THE ABILITY OF CALIFORNIA BUSINESSES TO COMPETE:

The Commissioner has made an initial determination that the proposed regulations may have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states. The types of businesses that may be affected are insurance companies. Insurance companies may incur some costs as a result of updating the way they calculate reserves. The Commissioner has considered performance standards, but the Commissioner has identified no performance standards that would be as effective as the proposed regulations in enforcing the statutes that form the basis for the proposed regulations. The Commissioner has not considered other proposed alternatives that would lessen any adverse economic impact on business and invites interested parties to submit proposals. Submissions may include the following considerations:

- (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to businesses;
- (ii) Consolidation or simplification of compliance or reporting requirements for businesses;
- (iii) The use of performance standards rather than prescriptive standards;
- (iv) Exemption or partial exemption from the regulatory requirements for businesses.

#### POTENTIAL COST IMPACT ON PRIVATE PERSONS OR ENTITIES/BUSINESSES:

The Commissioner has determined that for insurance companies subject to the proposed regulations there is likely to be some cost impact, although it will most likely be minimal. The cost impact would be the cost of changing some of the data which the insurer uses in its reserve calculations, with any resulting change in reserve amounts, and the cost of calculating reserves in a more updated way than in the past. The cost impact of complying with the proposed regulations has already been mitigated by the fact that



the NAIC Model Regulation has already been adopted in a number of states, and insurers doing business in those states are thereby already required to comply with the NAIC requirements, irrespective of whether or not the proposed regulations require it. Consequently, if California adopts regulations based on the NAIC Model, the additional work of these companies in complying with California's NAIC-derived requirements is likely to be minimal.

#### FINDING OF NECESSITY:

The Commissioner finds that it is necessary for the welfare of the people of the State that the regulations apply to businesses.

#### EFFECT ON JOBS AND BUSINESSES IN CALIFORNIA:

The Commissioner is required to assess any impact the regulations may have on the creation or elimination of jobs within the State of California as well as the creation of new businesses, the elimination of new businesses, and the expansion of businesses currently operating in the State. The Commissioner does not foresee that the proposed regulations will have an impact on any of the above but invites interested parties to comment on this issue.

#### IMPACT ON HOUSING COSTS:

The matters proposed herein will have no significant effect on housing costs.

#### ALTERNATIVES:

The Commissioner must determine that no reasonable alternative considered by the Commissioner or that has otherwise been identified and brought to the attention of the Commissioner would be more effective in carrying out the purposes for which the regulations are proposed or would be as effective as and less burdensome to affected private persons than the proposed regulations. The Commissioner invites public comment on alternatives to the regulations.

#### IMPACT ON SMALL BUSINESS:

The Commissioner has determined that the proposed regulations will not affect small businesses. Pursuant to Government Code section 11342.610(b)(2), insurers are not small businesses.

#### COMPARABLE FEDERAL LAW:

There are no existing federal regulations or statutes comparable to the proposed regulations.

#### TEXT OF REGULATIONS AND INITIAL STATEMENT OF REASONS:

The Department has prepared an Initial Statement of Reasons that sets forth the reasons for the proposed regulations. Upon request, the Initial Statement of Reasons will be made available for inspection and

copying. Requests for the Initial Statement of Reasons or questions regarding this proceeding should be directed to the contact person listed above. Upon request, the Final Statement of Reasons will be made available for inspection and copying once it has been prepared. Requests for the Final Statement of Reasons should be directed to the contact person listed above.

The file for this proceeding, which includes a copy of the proposed regulations, the Initial Statement of Reasons, the information upon which the proposed action is based, and any supplemental information, including any reports, documentation and other materials related to the proposed action that is contained in the rulemaking file, is available for inspection and copying by prior appointment at 45 Fremont Street, 24th Floor, San Francisco, California 94105, between the hours of 9:00 a.m. and 4:30 p.m., Monday through Friday.

AUTOMATIC MAILING:

A copy of the proposed regulations and this Notice (including the Informative Digest, which contains the general substance of the proposed regulations) will automatically be sent to all persons on the Insurance Commissioner's mailing list.

WEBSITE POSTINGS:

Documents concerning this proceeding will be available on the Department's website. The documents shall include the proposed regulations, the Notice of Hearing and Informative Digest, the Initial Statement of Reasons, and, when it has been prepared, the Final Statement of Reasons. To access documents concerning this proceeding, go to <http://www.insurance.ca.gov>. Find the link "QUICK LINKS" in blue in the middle of the screen. Click on the link for "Legal Information" under the "QUICK LINKS" link, then click on the "Proposed Regulations" link. When the search field appears, enter 'RH04041191' (the Department's regulation file number for these regulations).

MODIFIED LANGUAGE:

If the regulations adopted by the Department differ from those which have originally been made available but are sufficiently related to the action proposed, they will be available to the public for at least 15 days prior to the date of adoption. Interested persons should request a copy of these regulations prior to adoption from the contact person listed above.

Dated: August 23, 2005

JOHN GARAMENDI  
Insurance Commissioner

By: \_\_\_\_\_  
Susan Stapp

Assistant Chief Counsel

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